In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-701

ECONOMY FINANCE CORPORATION, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. App. A35-A56) is not officially reported. The opinion of the court of appeals (Pet. App. A1-A33) is reported at 501 F.2d 466.

JURISDICTION

The judgment of the court of appeals was entered on July 16, 1974 (see Pet. App. A1). A petition for rehearing was denied on September 6, 1974 (Pet. App. A57). The petition for a writ of certiorari was filed on December 4, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Section 801(a) of the Internal Revenue Code of 1954 provides that in order for an insurance company to qualify for tax treatment as a life insurance company, its

life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, health or accident policies not included in life insurance reserves must comprise more than 50 percent of its total reserves.

The question presented is whether the court of appeals correctly held that non-life insurance reserves should be attributed to petitioners for purposes of determining their qualification as life insurance companies under Section 801(a), where petitioners assumed the risk of the policies incident to such reserves pursuant to a reinsurance contract with another insurer.

STATUTE AND REGULATION INVOLVED

Section 801 of the Internal Revenue Code of 1954 and the pertinent provisions of Section 1.801-3 of the Treasury Regulations on Income Tax (1954 Code) are set forth at pages 4-5 of the petition.

STATEMENT

Petitioners were engaged in the business of reinsuring credit life and credit accident and health insurance. They reinsured the credit life and credit accident and health insurance issued by an independent insurer, Standard Life Insurance Company of Indiana ("Standard") (Pet. 5-6; Pet. App. A2, A38-A39). Under the arrangement, Standard reinsured 100 percent of the credit insurance risk with petitioners, pursuant to two separate reinsurance contracts, one for the credit life insurance and one for the credit accident and health insurance (Pet. 6; Pet. App. A3-A4). Under the life reinsurance contracts, Standard reinsured with petitioners 100 percent of each credit life insurance policy and would pay petitioners a reinsurance premium, which amounted to 98.3 percent of the gross monthly paid premiums, less commissions paid to the agent (Pet. App. A4).

Under the accident and health reinsurance contracts, Standard also reinsured with petitioners 100 percent of each accident and health policy and paid to them the reinsurance premium, which amounted to 98.3 percent of the "gross monthly earned premiums,"[1] less commissions paid and all other expenses (including taxes and claims) paid with respect to the accident and health insurance in the preceding month (Pet. App. A4-A5). However, the health and accident risks were reinsured "for a period of one month only," with a further provision for the reinsurance "automatically [to] renew itself from month to month until such time" as the policies reinsured expired or "until this treaty is cancelled as provided in Article IX" (Pet. App. A5-A6). It was further provided that petitioners would "have no right, title or interest in any unearned premiums or unearned premium reserves held by STANDARD"[2] (Pet. App. A5).

Relying on the fact that the reinsurance premiums were to be remitted on an "earned" basis, Standard reported the unearned premium reserves in its annual statement filed with the California Insurance Department. Petitioners did not report any portion of the unearned premium reserves in the annual statements filed with the Delaware insurance authorities (Pet. App. A7). In addi-

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[1]Under the reinsurance contract "gross monthly earned premiums" were defined as the pro rata part of the single premium corresponding to the duration of insurance coverage provided for in said policy during the preceding month (Pet. App. A5).

[2]It was stipulated (Pet. App. A7) that petitioners—

> reinsured credit accident and health insurance on a month-to-month basis, rather than for the full term of the policies, in order to avoid holding any unearned accident and health premium reserves and, therefore, reduce the amount of reserves which might be considered as non-qualifying reserves for the purpose of determining whether they were entitled to be taxed as life insurance companies under the reserve-ratio formula in § 801(a) of the Code.

tion, Standard would invest amounts roughly equivalent to the balance of the unearned accident and health premiums reserve in obligations of Economy Finance Corporation (one of the petitioners) and remitted the interest earned on these obligations to the agent, Schloss Insurance Agency (under common control with petitioners) (Pet. App. A2-A3, A7).

On their tax returns for 1959 and 1961, petitioners claimed that they qualified as life insurance companies under Section 801(a) of the Code because none of the accident and health reserves on the policies reinsured with them by Standard should be included in determining whether more than 50 percent of their total reserves were life insurance reserves. On audit, the Commissioner determined that the accident and health reserves on the policies reinsured with petitioners should be included in their total reserves. Accordingly, the Commissioner recomputed petitioners' tax liability on the basis that they were not life insurance companies and determined deficiencies (Pet. App. A2, A8-A9).

In these refund suits brought by petitioners, the district court held that because the reinsurance agreement was prompted by nontax business reasons, Standard and not petitioners was the proper party to establish and report the reserves on the reinsured accident and health business so that petitioners qualified as life insurance companies under the 50 percent rule of Section 801(a) (Pet. App. A8-A9, A50-A51). The court of appeals reversed, concluding that because the reinsurance contract with respect to the accident and health insurance did not spread the risk, the accident and health reserve should be attributed to petitioners. As a result, more than 50 percent of petitioners' reserves were attributable to non-life insurance so that they could not qualify as life insurance companies under Section 801(a) (Pet. App. A9, A19-A23).

ARGUMENT

1. Section 801(a) of the Code provides that in order for an insurance company to qualify for the special tax treatment accorded life insurance companies, its life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, health or accident policies not included in life insurance reserves must comprise more than 50 percent of its total reserves. As the Court of Claims explained in *Alinco Life Insurance Co.* v. *United States*, 373 F.2d 336, 346-347, this statutory test was intended to limit the favored tax status to companies conducting predominantly life insurance business as measured by their reserves. See also *National Protective Ins. Co.* v. *Commissioner*, 128 F.2d 948, 950 n. 3 (C.A. 8), certiorari denied, 317 U.S. 655.

Here, Standard agreed to pay petitioners a reinsurance premium equal to 98.3 percent of the gross monthly earned premiums less commissions and other expenses, including claims expenses (Pet. App. A4-A5, A43). Standard's interest was only in the commissions it received, which were not affected by the claims experience. Accordingly, it had no insurance risk (Pet. App. A19). Under the agreement, the premium payments retained by petitioners decreased as loss experience increased.

Hence, the court of appeals found that under the reinsurance agreement, petitioners had the ultimate risk of loss on the non-life accident and health insurance. It correctly concluded that for purposes of the statutory 50 percent test, the unearned premium reserves on this non-life business should be attributed to petitioners with the result that they did not qualify as life insurance companies under the statutory definition (Pet. App. A19, A22-A23).

Petitioners concede (Pet. 15) that the decision below is not in conflict with that of any other court of appeals.[3] They nevertheless argue (Pet. 11-12) that since there was a valid business reason for the reinsurance agreement, the court of appeals erred in ignoring it for tax purposes. However, whether or not there were business reasons (other than tax advantages) is irrelevant to the purpose of the 50 percent test of Section 801(a). As the court of appeals observed (Pet. App. A9):

> * * * accepting the legitimacy of that [business] purpose does not end the inquiry. The issue raised by the government is not whether taxpayers should actually have established H & A [health and accident] reserves but how such reserves should be considered for the limited purpose of determining taxpayers' qualifying ratio. This is not a question of form over substance but rather one of the proper characterization of the substance.

Thus, if the integrity of the 50 percent test of Section 801(a) is to be preserved, the fact that Standard recorded on its books the non-life reserves of the policies reinsured with petitioners is irrelevant. Cf. *Gregory* v. *Helvering*, 293 U.S. 465. For purposes of the statute, reserves should be attributed to the insurance company which in fact underwrites the risks of the policies, here petitioners. *Superior Life Insurance Co.* v. *United States*, 462 F.2d 945 (C.A. 4).

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[3]Despite the absence of any present conflict, the issue in this case continues to be litigated. On February 3, 1975, the Court of Claims, sitting *en banc*, heard argument on the inconsistent opinions of two of its Trial Judges on this issue. Compare *Penn Security Life Insurance Co.* v. *United States*, No. 109-68, decided March 2, 1973, with *Consumer Life Insurance Co.* v. *United States*, No. 463-70, decided December 13, 1974. Moreover, the issue is presently pending in the Fifth Circuit on the government's appeal in *First Railroad & Banking Co. of Georgia* v. *United States*, No. 73-3184.

At all events, to the extent that the tax motivation may be relevant, petitioners stipulated that the reason why the month-to-month basis of reinsuring credit accident and health insurance was chosen, rather than the full term of the policies, was (Pet. App. A7)—

> to avoid holding any unearned accident and health premium reserves and, therefore, reduce the amount of reserves which might be considered as non-qualifying reserves for the purpose of determining whether * * * [petitioners] were entitled to be taxed as life insurance companies under the reserve-ratio formula in § 801(a) of the Code.

Petitioners have therefore acknowledged that tax motivation played a role in the formulation of the arrangements in question.

2. Petitioners further contend (Pet. 14) that "the Seventh Circuit has forced a tax result inconsistent with insurance regulatory accounting" (Pet. 14).[4] But Standard was not "required" by any state regulation to carry these reserves and it does not appear that petitioners were precluded from carrying them by any state. Indeed, if petitioners had actually maintained the health and accident reserves in conformity with their assumption of the risk, Standard would not have been required to duplicate them. See National Association of Insurance Commissioners, *Examiner's Handbook* (Reinsurance Subcommittee Reports of 1961 NAIC Proceedings, Vol. 1, pp. 147-177),

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[4]There is no basis for petitioners' contention (Pet. 12-13) that the decision below jeopardizes the status of companies writing term insurance. Reserves are the traditional measure of insurance risks, whether those risks are assumed in a term or an ordinary policy. All this case holds (Pet. App. A7) is that for purposes of determining to which company the reserve should be attributed under Section 801(a), the reserves must be attributed to the company which bears the risk (Pet. App. A19, A22, A23, A28). See *Alinco Life Insurance Co.* v. *United States*, *supra*, where the Court of Claims held that short-term life insurance reserves are a life insurance reserve for tax purposes.

Part B, p. B14). Thus, the decision below is in no way inconsistent with state insurance regulatory requirements.

3. Finally, petitioners urge (Pet. 16) that this decision requiring that the gross unearned premium reserve—rather than the "net"—be included in the total reserves, is in conflict with *Alinco Life Insurance Co.* v. *United States, supra*; *Great Commonwealth Life Insurance Co.* v. *United States*, 491 F.2d 109 (C.A. 5); and Treasury Regulations on Income Tax, Section 1.801-3(e). *Alinco* and *Great Commonwealth*, however, involved life insurance reserves which are not computed on the same gross unearned premium basis as health and accident reserves. See Mehr & Cammack, *Principles of Insurance*, pp. 683-691 (1972 ed.). Hence, those cases are not pertinent authority with respect to the definition of unearned premium reserves on accident and health insurance, which are defined for tax purposes as the gross unearned premium reserve. See *Superior Life Insurance Co.* v. *United States, supra*, 462 F.2d at 951.

Petitioners' argument concerning Treasury Regulations, Section 1.801-3(e), was specifically rejected in *Superior Life Insurance Co.* v. *United States, supra*, a case involving the same type of credit accident and health insurance. There, the Fourth Circuit held that the gross unearned premium rather than the net unearned premium was included in the total reserves and that this was not inconsistent with Treasury Regulations, Section 1.801-3(e), which defines unearned premiums as "those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance." In so holding, the court stated that "both the morbidity portion and the loading portion are, we think, 'costs' of insuring" (462 F.2d at 951). The inclusion of the gross accident and health reserves in petitioners' reserves is therefore in complete conformity with the Regulation.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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